

**The Internal Revenue Service Does Not  
Effectively Use the Trust Fund Recovery  
Penalty as a Collection Enforcement Tool**

**November 2000**

**Reference Number: 2001-30-014**

**This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

November 6, 2000

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner  
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Internal Revenue Service Does Not Effectively Use the Trust Fund Recovery Penalty as a Collection Enforcement Tool

This report presents the results of our review of the trust fund recovery penalty as a collection enforcement tool. In summary, the Collection function does not consistently use this tool to enforce collection of trust fund taxes, and when utilized, it is used ineffectively, incorrectly, or too late in the process. We made five recommendations related to these issues.

Management's response was due on October 25, 2000. As of October 30, 2000, management had not responded to the draft report.

Copies of this report are being sent to the Internal Revenue Service managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Gordon C. Milbourn III, Associate Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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# **The Internal Revenue Service Does Not Effectively Use the Trust Fund Recovery Penalty as a Collection Enforcement Tool**

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## **Executive Summary**

The Collection Field function (CFf) in the Internal Revenue Service (IRS) is responsible for collecting tax liabilities owed by taxpayers. One of the CFf's highest work priorities is trust fund liability, which includes those taxes withheld from employees' wages. Employees who have taxes withheld from their wages expect the withheld funds to be properly deposited and credited to their accounts.

The CFf has a variety of collection tools and techniques for its use in collecting taxes, including the Trust Fund Recovery Penalty (TFRP) Program. The Internal Revenue Code<sup>1</sup> provides for this penalty to be assessed against responsible corporate officers for their willful failure to collect and remit trust fund taxes to the government. Although the CFf should consider other options for collecting the taxes owed, the CFf should make the decision to assess the penalty no later than 6 months after the account is received. By statute, the IRS must make this assessment within 3 years of the original trust fund tax assessment against the corporation.

The penalty should be assessed against trust fund "repeaters," which are those taxpayers with a certain number of delinquent accounts exceeding a specified dollar amount. The TFRP investigative process includes interviewing employees of the corporation, reviewing bank and corporate records, and identifying signatures on the tax returns and payroll checks. Once the CFf assesses the penalty, the IRS can then pursue collection actions against the responsible officers.

The overall objective of our review was to determine whether the TFRP is effectively used as an enforcement tool to encourage voluntary compliance. To accomplish our objective, we evaluated management direction and reviewed a judgmental sample of 82 trust fund accounts that had been assigned to the CFf.

## **Results**

The CFf does not effectively use the TFRP as a Collection tool. The 82 trust fund cases in our sample were assigned to the CFf as of September 1998 and, at that time, the taxpayers owed \$2,940,920. While some money has been collected on these cases, the taxpayers generally continued to incur additional tax liabilities. As of June 2000, they owed \$4,961,703. The status of these accounts was as follows (percentages are rounded):

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<sup>1</sup> 26 U.S.C. § 6672.

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- \$1,436,778 (29 percent) - assigned to the CFf (includes cases in installment agreement status).
- \$1,464,034 (30 percent) - written off as currently not collectible (i.e., the IRS determined that these accounts could not be collected).
- \$278,658 (6 percent) - in notice status.
- \$1,384,679 (28 percent) - housed in unassigned work inventory, known as the Queue.
- \$322,324 (6 percent) - suspended because taxpayers are in bankruptcy.
- \$75,230 (1 percent) - other.

### **The Collection Field Function Did Not Properly Complete Investigations and Make Decisions to Timely Assess the Trust Fund Recovery Penalty**

Our review of the 82 trust fund cases showed that, in 64 cases, the CFf did not assess the penalty. In 58 (91 percent) of the 64 cases, the CFf did not properly complete the investigative process or assess the penalty when appropriate. In the other 18 of the 82 cases, the CFf assessed the penalty but in 17 cases (94 percent) did not make the decision within the required 6-month time frame. The average time to recommend this assessment was 18 months after assignment to the CFf. Eleven of these 17 cases have since been written off as uncollectible. Overall, the CFf did not follow its procedures for timely deciding whether to assess the TFRP in 75 (91 percent) of the 82 cases. All of the 75 cases involved taxpayers who met the CFf criteria as repeaters.

In 32 (39 percent) of the 82 cases, the CFf initiated an installment agreement,<sup>2</sup> which delayed the TFRP investigation and assessment process. However, IRS guidelines state these agreements with repeater taxpayers are normally not appropriate. In addition, IRS procedures do not prevent both accepting an agreement and assessing the penalty to collect the taxes owed. Yet the CFf assessed the TFRP after accepting an agreement in only 7 of these 32 cases. These 7 were assessed because the taxpayer defaulted (i.e., did not make payments) or the statutory period for assessment was about to expire.

We also had other concerns with the investigative and assessment process. In 3 of the 18 cases in which the CFf assessed the penalty, it did not assess the penalty against all responsible officers. In addition, in 6 of the 64 cases, the CFf did not assess the TFRP because the total dollar liability was less than the specified threshold for assessment. However, in three of these six cases, the CFf did not consider returns that were due but

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<sup>2</sup> An installment agreement is a monthly payment arrangement.

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had not been filed. Liabilities on these unfiled returns could have increased the total liability over the threshold for assessing the TFRP.

Timely CFf actions help maximize the IRS' ability to collect delinquent tax liabilities. When assessments are not made timely against responsible officers, the financial ability of the officers could deteriorate, thereby decreasing the IRS' chances to collect the taxes due. A General Accounting Office (GAO) report entitled *Unpaid Payroll Taxes, Billions in Delinquent Taxes and Penalty Assessments Are Owed* (GAO/AIMD/GGD-99-211) was issued in August 1999. The GAO reported that the IRS collected very little of the TFRP liability. The fact that the CFf does not assess the penalty timely could be part of the cause for the low collection rate.

Reasons for the CFf's limited use of the TFRP include:

- The IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>3</sup> has made CFf employees reluctant to take enforcement actions against taxpayers because they are concerned that the Act allows taxpayers to sue IRS employees for harassment.
- The CFf management involvement in cases was not sufficient. Managers did not provide sufficient guidance in their reviews and, in some instances, did not make timely reviews. In addition, many managers did not believe that 6 months is a sufficient amount of time to reach a decision to use the TFRP.
- National Headquarters and CFf management do not have sufficient information regarding the quality of decisions by the CFf to use the TFRP.

### **Summary of Recommendations**

We recommend that Collection function management reassess the time frames for making the TFRP decision and provide clear instructions on using the TFRP and installment agreement procedures on repeater trust fund cases. Use of the TFRP as an effective Collection tool needs to be emphasized at all management levels, and management reviews need to be conducted on these priority cases. In a separate audit report entitled *The Collection Quality Measurement System's Process Can Be Enhanced* (Reference Number 2000-30-161, dated September 27, 2000), we recommended that this quality review process include the CFf's decision to assess the TFRP.

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<sup>3</sup> Pub. L. No. 105-206, 112 Stat. 685.

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Management's Response: Management's response was due on October 25, 2000. As of October 30, 2000, management had not responded to the draft report.

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## Objective and Scope

*The overall objective of the audit was to determine whether the TFRP is effectively used.*

The overall objective of the audit was to determine whether the Trust Fund Recovery Penalty (TFRP) is effectively used as an enforcement tool to encourage voluntary taxpayer compliance. To achieve this objective, we evaluated the management of the TFRP Program at the national and local levels.

We selected a judgmental sample of 160 Taxpayer Delinquent Accounts from 8 groups in 3 districts. We compared Internal Revenue Service (IRS) computerized account information from September 1998 to account information from April through June 2000. After eliminating those cases for which the TFRP was not applicable (such as fully paid accounts, partnership entities, and accounts with balances below the threshold amount for assessing the TFRP), we identified 82 cases for review. We also interviewed Collection function managers at various levels within the IRS.

We conducted fieldwork between April 2000 and July 2000 in the National Headquarters and the Michigan, New Jersey, and North-South Carolina Districts. The audit was performed in accordance with *Government Auditing Standards*.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to the report are listed in Appendix II.

## Background

*Trust fund liability is a high priority for the CFf.*

The Collection Field function (CFf) is responsible for collecting tax liabilities owed by taxpayers. One of the CFf's highest work priorities is trust fund liability, which includes:

- Income tax withheld from wages, including tips, supplemental unemployment compensation benefits, and third-party payments of sick pay.



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*IRS Form 941 is used to report business trust fund taxes.*

- Social Security and Medicare taxes.

Businesses use Employer's Quarterly Federal Tax Return (Form 941) to report these trust fund taxes. Employees who have taxes withheld from their wages expect the withheld funds to be properly deposited and credited to their accounts, and employers expect their competitors to pay their trust fund taxes.

The CFf has a variety of collection tools and techniques for its use in collecting taxes, including the TFRP Program. The Internal Revenue Code (I.R.C.)<sup>1</sup> encourages the prompt payment of withheld and other collected taxes and provides the IRS with a secondary source of collection in the event that these taxes are not paid. When trust fund taxes are not paid, the TFRP may be assessed against those officers responsible for the willful failure to collect or remit these taxes. I.R.C. § 6672 applies only to persons responsible for collecting trust fund taxes.

*Willfulness and responsibility must be determined prior to recommending the TFRP.*

Willfulness and responsibility on the part of the person(s) involved must be determined prior to recommending assessment of the TFRP. For the purpose of asserting the TFRP, a responsible person is defined as one who has the duty to perform or the power to direct the act of collecting, accounting for, and paying over trust fund monies. A responsible person may be an officer or employee of a corporation, a member or employee of a partnership, or a corporate director or shareholder with sufficient control over funds to direct disbursement of such funds.

To make the determination whether to assess the penalty, the CFf conducts an investigation. The investigative process includes interviewing employees of the corporation, reviewing bank and corporate records, and identifying signatures on the tax returns and payroll checks. Once the TFRP is assessed, the IRS can collect the penalty amount only once, either from the

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<sup>1</sup> 26 U.S.C. § 6672.

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corporation or from one or more of the responsible persons.

### **Results**

*The CFf does not effectively use the TFRP as a Collection tool.*

The CFf does not effectively use the TFRP as a Collection tool. In 75 (91 percent) of the 82 cases we reviewed, the CFf did not properly complete investigations and make decisions to timely assess the TFRP. The 82 trust fund cases in our sample were assigned to the CFf as of September 1998 and, at that time, the taxpayers owed \$2,940,920. While some money has been collected on these cases, the taxpayers generally continued to incur additional tax liabilities. As of June 2000, they owed \$4,961,703. The status of these accounts was as follows (percentages are rounded):

- \$1,436,778 (29 percent) - assigned to the CFf (includes cases in installment agreement status).
- \$1,464,034 (30 percent) - written off as currently not collectible (i.e., the IRS determined that these accounts could not be collected).
- \$278,658 (6 percent) - in notice status.
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- \$322,324 (6 percent) - suspended because taxpayers are in bankruptcy.
- \$75,230 (1 percent) - other.

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### **The Collection Field Function Did Not Properly Complete Investigations and Make Decisions to Timely Assess the Trust Fund Recovery Penalty**

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IRS procedures require that the CFf assess the TFRP against trust fund “repeaters,” which are those taxpayers with a certain number of delinquent accounts exceeding a specified dollar amount.

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Although the CFf should consider other options for collecting the taxes owed, the CFf should make the decision to assess the penalty no later than 6 months after it receives the account. By statute, the IRS must make this assessment within 3 years of the original trust fund tax assessment against the corporation.

Our review of the 82 trust fund cases showed that, in 64 cases, the CFf did not assess the penalty. In 58 (91 percent) of the 64 cases, the CFf did not properly complete the investigative process or assess the penalty when appropriate. In the other 18 of the 82 cases, the CFf assessed the penalty; however, 17 cases (94 percent) were not recommended for assessment within the required 6-month time frame. The average time to recommend this assessment was 18 months after assignment to the CFf. Eleven of the 17 cases have since been written off as uncollectible. Overall, the CFf did not follow its procedures for timely deciding whether to assess the TFRP in 75 (91 percent) of the 82 cases. All of the 75 cases involved taxpayers who met the CFf criteria as repeaters.

During our discussions with CFf managers, they stated they did not believe that 6 months was a sufficient amount of time to make the TFRP investigation and decision. However, when assessments are not made timely against responsible officers, the financial ability of the officers could deteriorate, thereby decreasing the IRS' chances to collect the taxes due. A General Accounting Office (GAO) report entitled *Unpaid Payroll Taxes, Billions in Delinquent Taxes and Penalty Assessments Are Owed* (GAO/AIMD/GGD-99-211) was issued in August 1999. The GAO reported that the IRS collected very little of the TFRP liability. The fact that the CFf does not assess the penalty timely could be part of the cause for the low collection rate.

In addition, the CFf frequently accepted installment agreements on repeater taxpayers, did not assess the penalty against all responsible officers, and did not include unfiled returns during the TFRP assessment process. There were various reasons why the TFRP was

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not used more effectively, which are discussed in more detail later in the report.

### **The CFf accepted installment agreements on repeater taxpayers and delayed the TFRP process**

The CFf may enter into installment agreements<sup>2</sup> with taxpayers. However, the Internal Revenue Manual (IRM) states “normally an installment agreement is not appropriate for repeater taxpayers.”

In addition, IRS procedures do not prevent both accepting an agreement and assessing the TFRP to collect the taxes owed. When a repeater taxpayer signs an installment agreement, the taxpayer should understand that the CFf will also assess the TFRP.

*TFRP investigations and assessments were delayed for taxpayers with installment agreements.*

However, in 32 (39 percent) of the 82 cases, the CFf initiated an installment agreement, which delayed the TFRP investigation and assessment process. Further, the CFf assessed the TFRP after accepting the agreement in only 7 of these 32 cases, because the taxpayer defaulted (i.e., did not make payments) or the statutory period for assessment was about to expire. Our discussions with the CFf managers showed that they did not clearly understand either the procedures for accepting installment agreements on repeater taxpayers or the provision for also assessing the TFRP.

### **The CFf did not always assess the TFRP against all responsible officers**

The IRM requires that when a decision to assess the TFRP is made, the penalty should be assessed against all responsible officers of the business. The CFf should interview employees of the business and review pertinent records, such as bank, payroll, and tax return records. If penalties are not assessed against all responsible officers, the IRS’ chances to collect the funds are diminished and taxpayers are not treated fairly.

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<sup>2</sup> An installment agreement is a monthly payment arrangement.

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As previously stated, there were 18 cases in our review in which a penalty had been assessed. However, in three of these cases the penalty was not assessed correctly against all responsible officers. In fact, in one instance, the officer received a refund on his/her personal tax return.

### **The CFf did not always consider unfiled returns when determining whether to assess the TFRP**

*Delinquent returns are inadequately considered in the TFRP process.*

The TFRP is to be assessed when the total amount of tax liability exceeds a specific dollar amount. In 6 of 64 cases in our review, the CFf did not assess the penalty because the total dollar amount was below the threshold for assessing the TFRP. However, in three of those cases, the taxpayers had returns that were due but not filed at the time the CFf performed the TFRP calculations. Liabilities on these unfiled returns could have increased the total liability over the TFRP threshold. Also, in a case in which the CFf assessed the TFRP, unfiled returns were not included in the assessment.

*The ATFR system does not account for open trust fund delinquent returns due.*

Part of the CFf's compliance check is to secure delinquent returns or prepare substitutes when originals are not filed. However, the new automated system used to calculate the TFRP assessment, the Automated Trust Fund Recovery (ATFR) system, does not adequately account for open trust fund delinquent returns due. Specifically, the ATFR system, which went on-line nationally on June 19, 2000, computes the TFRP amount based on balances due but does not include unfiled returns.

When delinquent returns are not considered in TFRP calculations, the trust fund portions of dollars owed are understated. Consequently, the CFf may not assess the TFRP because the total dollar amount may be below the threshold for making the assessment or may assess an incorrect amount of penalty.

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### Reasons why these problems occurred

Based on our review of cases and discussions with Cff management, we identified three reasons why the Cff did not effectively use the TFRP:

*The RRA 98 has made many Collection function employees fearful of using the TFRP.*

- The IRS Restructuring and Reform Act of 1998 (RRA 98)<sup>3</sup> has made many Collection function employees fearful of using the TFRP, because to do so might bring about a termination for misconduct action under RRA 98 § 1203(b) provisions. Managers specifically told us:  
“...[the] post-RRA 98 atmosphere has Collection staff hesitant to pursue any enforcement action that may be construed as hostile or detrimental to a taxpayer...ROs [Revenue Officers] are reluctant to do or say anything that may upset a taxpayer....”  
“...RRA 98 mandates have caused confusion among the Collection staff. They are unsure what is appropriate behavior...the TFRP has become a Collection leverage tool often mentioned but seldom enacted....”  
“...RRA 98...[makes]...ROs hesitant to be forceful and they are not using all the Collection enforcement tools effectively or consistently....”

*Management involvement in the TFRP Program is insufficient.*

- Cff management involvement in the TFRP Program is also inadequate. Managers did not always review cases timely or provide sufficient guidance. For example, moratoriums were set on conducting group manager reviews because of labor issue concerns in one district and natural disaster relief in two districts. Consequently, in one district, reviews have been permitted for a total of only 6 months since 1997. In addition, managers did not clearly understand procedures for accepting installment agreements and assessing the TFRP against responsible taxpayers.

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<sup>3</sup> Pub. L. No. 105-206, 112 Stat. 685.

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*The IRS does not have an objective method for evaluating the TFRP Program.*

Group managers also did not believe that 6 months is a sufficient amount of time to conduct the TFRP investigation and to reach a decision to assess the penalty.

- The IRS does not have an objective method for evaluating the TFRP Program. The Collection Quality Management System (CQMS) is a quality process in which various aspects of closed collection cases are evaluated. Currently, the CQMS does not address TFRP-related issues. In another audit report, *The Collection Quality Measurement System's Process Can Be Enhanced* (Reference Number 2000-30-161, dated September 27, 2000), we recommended that the TFRP decision be added to the actions being evaluated under the CQMS.

### Recommendations

The Assistant Commissioner (Collection)<sup>4</sup> should:

1. Reassess the time frames for making the TFRP decision. If 6 months is the appropriate period, the importance of timely use of this Collection tool should be reinforced.
2. Clarify instructions for accepting installment agreements and assessing the TFRP on repeater cases.
3. Reinforce the need for group managers to review repeater trust fund cases and consider the timely use of the TFRP.
4. Reinforce to group managers the need to assert the penalty against all applicable responsible officers.
5. Make programming changes to the ATFR system to

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<sup>4</sup> Effective October 1, 2000, this position no longer exists. The correct title would now be Small Business/Self-Employed Director, Compliance.

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ensure delinquent returns are addressed in TFRP calculations. These changes could include inserting logic provisions in the form used to calculate the TFRP.

Management's Response: Management's response was due on October 25, 2000. As of October 30, 2000, management had not responded to the draft report.

### **Conclusion**

Timely CFf actions are necessary to increase the IRS' ability to collect delinquent tax liabilities. When TFRP assessments are not made timely against responsible officers, the financial ability of the officers could deteriorate, thereby decreasing the IRS' chances to collect the taxes due. In a report issued in August 1999, the GAO determined that the IRS collected very little of the TFRP liability. Our review indicates that the CFf does not assess the penalty timely or sometimes at all, thereby contributing to the low collection rate for trust fund taxes.



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## **Appendix I**

### **Detailed Objective, Scope, and Methodology**

The overall objective of this review was to determine whether the Trust Fund Recovery Penalty (TFRP) is effectively used as an enforcement tool to encourage voluntary taxpayer compliance.

We used judgmental samples to perform our case review. Specific information regarding our sample selection methodology is detailed in sub-objectives I and II below. Trends identified among our specific sample cases may not reflect statistically valid results or trends at the national level.

In order to accomplish our overall objective, we:

- I. Evaluated the management of the TFRP as a Collection enforcement tool at national and local levels.
  - A. Reviewed national read files to identify direction given to the field regarding the TFRP and evaluated the extent of such direction.
  - B. Reviewed read files at the district, branch, and group levels to identify communication both up and down the Internal Revenue Service (IRS) organizational structure regarding the TFRP and evaluated the extent of such direction.
  - C. Interviewed Collection function personnel to obtain current perceptions of the TFRP.
  - D. Determined and assessed the methods used to evaluate the TFRP, either as a specific program or as a tool among other Collection programs.
  - E. Determined and assessed future plans for the TFRP either as a specific program or as a tool among other Collection programs.
  - F. Interviewed Collection function managers responsible for groups selected for review to obtain basic flowchart structures for TFRP processing.
  - G. Identified and assessed the ways automating current manual TFRP processes will bring about change (e.g., how technical decisions, such as appropriateness and timing of action, will be affected).

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- H. Determined and evaluated the coverage given the TFRP (either as a specific program or as a tool among other Collection programs) in the Collection Quality Management System.<sup>1</sup>
- II. Evaluated the application of the TFRP as a Collection enforcement tool through a review of both open and closed field Collection cases.
  - A. To select an appropriate judgmental sample of trust fund cases for review, we:
    - 1. Secured the Delinquent Investigation Account Listing (DIAL)<sup>2</sup> for September 1998 for the three districts selected for review.
    - 2. Isolated the sections of the September 1998 DIAL for eight groups selected for review.
    - 3. Isolated the populations of trust fund tax modules for the eight selected groups.
    - 4. Identified for each group population of trust fund tax modules the unique number of taxpayers represented.
    - 5. Selected 20 taxpayers from each group's unique taxpayer population. In the report, we use the term "case" to denote a single taxpayer and all applicable trust fund modules (there may have been more than one module per taxpayer). This population included a mix of open and closed modules.
  - B. Conducted reviews of 160 sample taxpayer cases from 8 groups using the following data sources:
    - 1. Integrated Data Retrieval System (IDRS)<sup>3</sup> Command Codes SUMRY, TDINQ, and BMFOL.

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<sup>1</sup> The Collection Quality Management System is a quality process in which various aspects of closed collection cases are evaluated.

<sup>2</sup> The DIAL is an inventory control tool that reflects all Taxpayer Delinquent Account and Taxpayer Delinquency Investigation modules assigned to the Collection Field function, per the Integrated Data Retrieval System, and is generated monthly by the service centers.

<sup>3</sup> The IDRS is one of the IRS' taxpayer database systems. TDINQ requests the display of entity and module data; it will give the assignment code of a selected Taxpayer Identification Number (TIN) or Employer Identification Number (EIN). SUMRY requests a summary of an account on the IDRS for a specific TIN or EIN. BMFOL with definers requests an index of tax modules showing posted returns, payments, adjustments, general entity information, status history, and audit history.

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2. Integrated Collection System/Entity<sup>4</sup> sample case histories generated by Collection function management and secured either before or on the first date of visitation in field offices.
3. Other applicable paper documents located in physical case files housed in various offices of the three districts selected for review.

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<sup>4</sup> The Integrated Collection System (ICS) is part of the IRS' plan for overall automation of its activities. This system, developed for the Collection function, captures all collection activity in a single record for review and/or casework notation. Entity is a system that displays all the information that would typically appear on the IDRS SUMRY or ENMOD screens. While both applications are available to Revenue Officers (RO) and management, the ICS is used more as a tool of the RO, and Entity, because it has query features that are more useful to management, is a tool for management. ICS/Entity was implemented nationwide in March 2000.

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**Appendix II**

**Major Contributors to This Report**

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Corporate Programs)

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**Appendix III**

**Report Distribution List**

Deputy Commissioner Operations C:DO  
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